Exploration of Non-Professional Ownership Structures for Audit Firms

Consultation Report

TECHNICAL COMMITTEE
OF THE
INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS

September 2009

This paper is for public consultation purposes only. It has not been approved for any other purpose by the IOSCO Technical Committee or any of its members.

Foreword

The IOSCO Technical Committee has published for public comment this consultation report on Exploration of Non-Professional Ownership Structures for Audit Firms.

We welcome empirical data and economic information, as well as anecdotal experience from investors, auditors, issuers, and other stakeholders on the following discussion and inquiries.

How to Submit Comments

Comments may be submitted by one of the three following methods **on or before 15 January 2010.** To help us process and review your comments more efficiently, please use only one method.

1. E-mail

- Send comments to Greg Tanzer, Secretary General, IOSCO at the following email address: AuditOwnership@iosco.org.
- **The subject line of your message should indicate "Public Comment on the Exploration of Non-Professional Ownership Structures for Audit Firms: Consultation Report."**
- Please do not submit any attachments as HTML, GIF, TIFF, PIF or EXE files.

OR

2. Facsimile Transmission

Send a fax for the attention of Greg Tanzer using the following fax number:
+ 34 (91) 555 93 68.

OR

3. Post

Send your comment letter to:

Greg Tanzer
Secretary General
International Organization of Securities Commisions
C / Oquendo 12
28006 Madrid
Spain

Your comment letter should indicate prominently that it is a "Public Comment on the Exploration of Non-Professional Ownership Structures for Audit Firms: Consultation Report"

<u>Important</u>: All comments will be made available publicly, unless anonymity is specifically requested. Comments will be converted to PDF format and posted on the IOSCO website. Personal identifying information will not be edited from submissions.

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I. Introduction

The International Organization of Securities Commissions' Audit Services Task Force (Task Force) is concerned with the risks to the capital markets presented by concentration in the market for large public company audit services,[1] in particular the impact concentration may have on the continued availability of audit services. The Task Force, which is comprised of securities regulators from across the globe, recognizes the importance of addressing responsibly the present state of concentration and further concentration that can be expected if a large audit firm leaves the market.

To that end, the Task Force has considered, including at its *2007 Roundtable on the Quality of Public Company Audits,* potential barriers to entry that may hinder the emergence of greater choice for large issuers in this market, including, *inter alia*, (1) auditing firm ownership restrictions; (2) the ability to attract human capital; (3) the hardship to potential entrants in the market of attracting large public company business from existing audit firms because of, among other things, the difficulty of developing reputational branding; and (4) the substantial required upfront expenditures to develop international professional networks and resources to capably audit large public companies.

In this report, the Task Force focuses on the impact of audit firm ownership restrictions on concentration in the market for auditing large issuers,[2] but the Task Force recognizes that the ultimate strategy for reducing concentration may need to address several barriers to entry (and any related solutions) together. The Task Force decided, as a beginning step, to consider the ownership restrictions, because while other market barriers are akin to business considerations that deter but do not legally prohibit some potential entrants to the large public company audit services market, ownership restrictions limit such entrants by law or regulation. Thus, while addressing other barriers may make market entry more desirable from a business standpoint ownership restrictions can continue to bar motivated potential participants from the large public company audit market.

The Task Force acknowledges that this report's focus on ownership restrictions is only a starting point in analyzing the causes and potential solutions to the problem of concentration and that there may be other solutions. Although in many jurisdictions securities regulators do not have the authority to affect change in audit firm ownership restrictions, the importance of availability of audit services to securities regulators' goals of protecting investors, ensuring that capital markets are fair, efficient, and transparent and reducing systemic risk makes an analysis of the issues surrounding ownership restrictions by the Task Force appropriate.[3]

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1 This paper only addresses the environment for large public company issuers. Smaller public companies, by virtue of their size, may have greater choices among auditors than the largest companies.

2 Audit firm concentration has been explored in several jurisdictions including by the European Commission, the United Kingdom's Financial Reporting Council, and the U.S. General Accounting Office (GAO). The Task Force consulted these studies when developing this paper from the perspective of securities regulators.

3 *See generally* International Organization of Securities Commissions, *Objectives and Principles of Securities Regulation*, (May 2003), http://www.iosco.org/library/pubdocs/pdf/IOSCOPD154.pdf.

This report begins by describing the current state of audit firm concentration in the market for auditing large public companies and securities regulators' observations regarding concentration on the availability of audit services. The report then explores the potential benefits for the availability of audit services of removing ownership restrictions. The report also discusses the adverse impact that removing ownership restrictions may have on audit firm competence, professionalism, independence, and audit quality, and solicits public comment on whether alternative legislative or regulatory mechanisms could sufficiently mitigate risks presented by a relaxation of ownership restrictions. The report necessarily considers the pros and cons of authorizing alternative forms of audit firm ownership and governance models in light of the mandate of securities regulators to protect investors, maintain fair and orderly markets, and promote capital formation.

The Task Force seeks public input on the following:

1. **Should regulators and/or legislators address barriers to entry in the market for large public audit services? Why or why not? Please explain.**

2. **What are the most significant barriers to entry in the market for large public company audit services? How can legislators and/or regulators address these barriers? Are there ways aside from addressing audit firm ownership restrictions to address audit firm concentration and concerns about the availability of audit services to large public companies?**

3. **Is increasing the availability of the sources of audit services to large public companies by addressing one of the barriers to entry into the market possible? If so, which one? If not, is addressing several or many of the barriers at one time necessary? If so, which ones?**

II. Audit Firm Concentration

The high degree of concentration in the audit services market for large public companies concerns securities regulators because of the potentially disruptive impact on the efficient functioning of the capital markets of the dissolution of one of the Big Four auditing firms (Deloitte Touche Tohmatsu, Ernst & Young, KPMG and PricewaterhouseCoopers). Currently, some larger public companies feel that their choices in audit firms are limited and use some or all of the remaining perceived choices in audit firms to perform non-audit services; therefore, certain large public companies believe that current auditor independence standards could create a situation in which, in the event that their existing auditing firm dissolves, their selection of another auditing firm is either impossible or significantly limited because of auditor independence rules.

The perception is that, in this environment, large public companies would be unable to obtain audits on a timely basis, negatively impacting investors. Given that most jurisdictions require public companies to submit audited financial statements, and that securities regulators and investors rely upon those audits, the continued availability of audit services is of critical importance. Accordingly, the Task Force is exploring concentration and barriers that prevent the increase in the number of auditing firms that compete in the audit market for large public companies and the disruption to the capital markets that could be generated by the loss of another Big Four firm. At the same time, the Task Force is keen to preserve the objectivity, independence, professionalism and competence of auditors, and thus, audit quality.

To illustrate the current state of concentration in the market for audit services to large issuers, in January 2008, the U.S. Government Accountability Office (GAO) concluded that, in 2006, the four largest auditing firms audited 98% of the 1,500 U.S. public companies with annual revenues over $1 billion, and 92% of U.S. public companies with annual revenues between $500 million and $1 billion.[4] Further, in 2007, the global revenues of each of the Big Four ranged between EUR 15 billion and 20 billion per year while the revenues for the next six largest audit firms following the Big Four ranged between EUR 2 billion and 3.7 billion per year.[5]

Many large public companies conduct business internationally, and the complexities of many of the industries in which they operate present challenges to their financial reporting responsibilities. Accordingly, many large public companies seek audit firms that have the international breadth and specific industry expertise to satisfy the needs of their audits.[6] Large audit firms evolved

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[4] U.S. Government Accountability Office, *Audits of Public Companies: Continued Concentration in Audit Market for Large Public Companies Does Not Call for Immediate Action*, 2 (Jan. 2008), http://www.gao.gov/new.items/d08163.pdf.

[5] European Commission, Directorate General for Internal Market and Services Working Paper: *Consultation on Control Structures in Audit Firms and Their Consequences on the Audit Market*, 3 (Nov. 2008), http://ec.europa.eu/internal_market/auditing/docs/market/oxera_consultation_en.pdf.

[6] U.S. Government Accountability Office, *supra* note 4, at 17.

over time to become geographically-dispersed, deploying common worldwide audit methodologies and developing specific industry expertise.

To facilitate the rapid expansion of auditing firms' global reach, several firms merged, which reduced the number of service providers to the large public company audit market. In addition, in the wake of the U.S. government's criminal indictment of Arthur Andersen in 2002, the firm's large public company clients changed their auditor, in most cases to one of the other Big Four firms. This migration effectively removed Arthur Andersen from the large public company audit market and further reduced the auditor choices available to large companies. Since the demise of Arthur Andersen, no new entrant has emerged to challenge the dominance of the Big Four in the market for large public company audits.

III. Ownership Restrictions as a Barrier to Entry

As a starting point to analyzing this state of concentration, the Task Force determined to examine the potential effects of removing restrictions that require all or a majority of the owners of audit firms to be licensed practitioners. The Task Force acknowledges that analyzing this potential barrier to entry may be only one part of a multifaceted strategy in potentially addressing the matter of concentration, as many other factors have led to and perpetuate the current state of concentration. Many IOSCO member jurisdictions require that firms be wholly or majority owned and controlled by practicing licensed accounting professionals. While these restrictions dictate who may own and control a firm and do not require that a firm adopt a particular legal structure (*e.g.*, partnership or corporation), many firms have organized as partnerships and do not raise capital through public markets.[7]

Current limits on potential owners and investors in audit firms can restrict audit firms from accessing sources of ownership capital that could otherwise be used to create or develop firms capable of auditing the world's largest companies and competing with the Big Four.[8] Creating the necessary infrastructure to audit large public companies requires a significant amount of overhead to support international operations and a large and sophisticated pool of human capital with appropriate technical expertise. For example, international auditing firms require resources to implement and maintain common auditing methodologies, information technology platforms, and internal monitoring and oversight policies and procedures to ensure the effectiveness of these firms' audits.

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7 In fact, in many IOSCO member jurisdictions, firms can choose any legal form available under the local law that best supports their business goals, provided that the firm complies with the regulatory requirements of each country in which it is organized. Ireland and Japan are two exceptions. Ireland requires audit firms to be either a sole trader or an unlimited liability partnership. Oxera Consulting Ltd, *Ownership rules of audit firms and their consequences for audit market concentration*, 48 (Oct. 2007), http://ec.europa.eu/internal_market/auditing/docs/market/oxera_report_en.pdf.

Prior to the amendment of the CPA Act in 2007, Japan required audit firms to adopt general partnership-type liability structures. To accommodate the recent significant rise in the number of partners at audit firms, the CPA Act now allows audit firms to adopt limited liability company-like liability structures. *See* Certified Public Accountants Act, Article 34-25 and Article 34-34, http://www.fsa.go.jp/common/law/02.pdf.

8 The 2007 study commissioned by the European Commission's Director General for Internal Market and Services ("Oxera Study") concluded that outside investors may be an effective mechanism for funding the expansion of small to mid-size firms into the large public company audit services market. The Oxera study concluded that:

> [R]elaxation of the current ownership and/or management rules could … create the opportunity for firms to explore alternative structures and choose the optimal one, given the various options that would become available. In contrast, under the current rules, audit firms as well as potential investors, might be restricted in their ability to choose the optimal corporate structure and the preferred financing structure. By giving firms at least the possibility of access to cheaper, outside capital, new entry opportunities may be created.

Oxera Consulting Ltd., *supra* note 7, at iii–iv. However, other studies have questioned whether relaxing ownership restrictions would have such an effect. *See* discussion, *infra*, Section VI.

Permitting broader ownership might increase the number of providers of audit services for large public companies. For example, permitting broader ownership might encourage new entrants to enter the market, including through expanded capital-raising in public markets. Permitting broader ownership could also offer existing non-Big-Four firms additional possible sources of financing for expansion into the large public company audit services market.[9] Also, allowing for non-practitioner ownership might enlarge the sophisticated pool of human capital with appropriate technical expertise, such as information technology, financial engineering, or legal services, which could contribute to improvements in the quality of audit services and governance. In addition, if one of the Big Four firms suddenly exited the market, permitting broader ownership may provide greater flexibility for governments to implement transitional or contingency measures designed to ensure that large public companies continue to have audit services available to them. For instance, the absence of ownership restrictions could facilitate the rapid creation of a new audit firm to replace one or more firms leaving the market, and modified ownership rules could allow for quicker recapitalization of a major firm.

The Task Force seeks public input on the following:

4. **Would expanding the scope of non-practitioner ownership create, alleviate, or remove any threats to the continuity of audit services? Please explain.**

5. **Could allowing audit firms the option of broader non-practitioner ownership, including through public sources, assist new competitors to enter the market for large public company audits? Please explain.**

6. **Would allowing audit firms the option of broader non-practitioner ownership allow for greater transitional flexibility to constitute a new firm or otherwise provide continuity of audit services in the event that one of the Big Four firms leaves the market?**

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9 As explained more fully in Section VI, existing studies indicate that small and mid-size firms do not necessarily view access to capital, by itself, to be a significant barrier to their expansion and that they might not take advantage of the expanded avenues for financing.

IV. Audit Firm Ownership Restrictions: Background

A. Existing Restrictions

Examples of jurisdictions that place restrictions on firm ownership are the EU, the United States and Japan. In 2002, the European Union enacted *Statutory Auditors' Independence in the EU: A Set of Fundamental Principles (Principles)*.[10] The Principles reinforced auditor independence obligations and required that the majority of the voting rights in a firm be held by those permitted to undertake statutory audits within the EU (*i.e.*, qualified auditors).[11] Furthermore, the Principles provided that a firm's internal governance framework must contain provisions stating that a non-auditor could never gain control of the firm.[12] Most recently, the European Union reinforced existing firm ownership rules when it enacted Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC (Eighth Directive). Specifically, the Eighth Directive requires that a majority of the voting rights in an audit firm and a majority, up to a maximum of 75 percent, of the firm's administrative or management body be held by licensed accountant practitioners.[13]

Similarly, in the United States, the individual states, which are responsible for licensing public accountants, have historically regulated audit firm governance and have long required that a majority of audit firm owners be licensed accountants.[14] Japan also restricts firm ownership. Prior to the amendment in 2007, Japan's Certified Public Accountants Act (CPA Act) prohibited non-practitioners from owning an audit firm. Adopting the principle that a broader array of professional skills, such as management, finance, information technology, and legal, is essential in maintaining quality of audit services and ensuring effective firm-wide governance, the CPA Act now allows for non-practitioner ownership, provided the total number of non-practitioner partners, both in terms of overall owners and managing partners, does not exceed 25 percent.[15]

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10 Commission of the European Communities, *Statutory Auditors' Independence in the EU: A Set of Fundamental Principles* (May 2002), http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2002:191:0022:0057:EN:PDF

11 *See id.* at Article 4.3.1.

12 *Id.*

13 European Parliament and Council of the European Union, Directive 2006/43/EC, *Approval of statutory auditors and audit firms*, Chap II, Article 3 (May 2006), http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2006:157:0087:0107:EN:PDF

14 *See, e.g.*, The Uniform Accountancy Act Fifth Edition, *Standards for Regulation Including Substantial Equivalency*, (July 2007), http://www.aicpa.org/download/states/UAA_Fifth_Edition_January_2008.pdf.

15 Certificate Public Accountants Act, Article 34-4 (3) and Article 34-13 (4) (2007), http://www.fsa.go.jp/common/law/02.pdf.

B. Rationale Underlying Ownership Restrictions

Ownership restrictions resulted in large part from concerns related to the importance for auditors of independence, audit quality, and professionalism and competence. Accordingly, a discussion of altering these restrictions requires an analysis of the potential adverse effects that modifications may have on those goals, including an examination of whether existing restrictions remain necessary to protect them.

1. Requiring Owners to Have Public Interest Obligations

A reason often advanced for limiting ownership of audit firms to licensed accountants is that practitioners have a public interest mandate as a result of the conditions under which the law grants their licenses in most jurisdictions. Public accounting, given its importance to the public, has long been considered a learned profession requiring an acceptable level of competence (*e.g.*, through education, experience, and certification). Limiting majority ownership and control to individuals who meet acceptable licensing credentials arguably promotes competence and a culture of professionalism, and prevents non-practitioners from influencing, through management or control, the attestation practice without having the attendant competence, professional obligations and experience. The practitioner's status as an accounting professional subject to attendant obligations is believed to temper the firm's focus on its economic interests and provide assurance that management decisions are made with the benefit of professional knowledge and obligation to the public interest. In addition, the impact of an adverse judgment arising from a violation of professional standards could be greater for practitioners, increasing the deterrent effect of liability. Unlike outside investors whose losses, depending on their level of control or participation in the firm's governance or management, would generally be limited to their investment, practitioner liability can threaten an auditor's professional reputation and future prospects, in addition to damages owed in any particular case. Further, practitioners must maintain knowledge of ethics and independence requirements to keep their certifications or licenses in many countries. This training is meant to cultivate values within audit firms based on ethics and independence principles. On the other hand, imposing similar obligations on non-practitioner investors may not be feasible in all jurisdictions. In this view, ownership by professionals reduces the pressures on audit firms to make decisions based upon economic or other incentives that may be in conflict with the public interest.

For example, if a firm were owned by a majority of non-practitioners, the economic desire to generate a high return on investment may create pressures for a firm to place increased focus on cutting costs in areas such as training, development of firm methodologies and best practices, and national office or other technical expertise. Each of these actions could provide short-term economic improvements, but may likely have long-term negative effects on audit quality. Therefore, many believe that restricting majority ownership of auditing firms to practitioners who operate with a public interest perspective and who have a significant and direct vested interest in the continuing viability of the firm helps mitigate the effect of such economic incentives. As a result, requiring a majority of ownership by licensed practitioners may decrease the likelihood that outside owners could assert influence to negatively affect an audit firm's attestation practice.

2. Conflicts of Interests

Another reason for the current ownership restrictions is to mitigate conflicts of interest between an auditor and its audit client. If an accounting firm were publicly owned, a danger exists that its shareholders could include persons affiliated with the firm's audit clients, creating conflicts of interest.[16] The International Federation of Accountants (IFAC) has identified the principal auditor independence concerns that are, in general, recognized on a global basis as significant "threats" to an audit firm's independence: (1) the self-review threat; (2) the self-interest threat; (3) the familiarity threat; (4) the advocacy threat; and (5) the intimidation threat.[17]

C. Limitations of the Current Restrictions with Respect to Independence, Audit Quality, and Professionalism and Competence

While the current ownership restrictions address in part some of the objectives to which they are directed, such as reinforcing the public interest commitments of licensed auditors and reducing conflicts of interest, some may argue that they may not be sufficiently tailored to achieve their desired ends. As noted above, some believe that current restrictions may diminish the availability of broader sources of capital better insulating investors and markets from the risks to continuity of audit services.

In addition, the Big Four firms are currently managed by owner-practitioner boards and do not employ alternative governance structures, such as an independent[18] board of directors for

16 An example of the problem arose in Germany in the early 20th century, when banks created trust companies "to manage and monitor their portfolio of assets." Oxera Consulting Ltd., *supra* note 7, at 22. Following the German banking crisis in 1931, audits of bank financial statements became mandatory and the trust companies began providing audit and consulting services. *Id*. Concerns about conflicts of interest arose because the banks owned the very trust companies that were conducting audits of their portfolios. *See id*. In 1961, Germany passed the Law Regulating the Profession of Auditors restricting non-practitioner ownership of firms, seeking to ensure that the types of conflicts represented in the bank-trust company relationship would not be replicated. *See id.*

17 Section 100.10 of the IFAC Code of Ethics for Professional Accountants indicates these threats may occur as a result of the following:

Self-review threat – when the previous judgment needs to be re-evaluated by the professional accountant responsible for that judgment;
Self-interest threat – judgments of a professional accountant may be influenced by his or her own financial or other interests or those of an immediate or close family member;
Familiarity threat – a close relationship causes a professional accountant to become too sympathetic to the interests of others;
Advocacy threat – a professional accountant promotes a position or opinion to the point that subsequent objectivity may be compromised; and
Intimidation threat – a professional accountant may be deterred from acting objectively by threats, actual or perceived.

Code of Ethics for Professional Accountants, *Handbook of International Auditing, Assurance, and Ethics Pronouncements*, Part I, 18–19 (2008 Ed.). The Task Force notes that the IFAC Code of Ethics for Professional Accountants was updated in July 2009 and is effective January 1, 2011, with early adoption permitted. The July 2009 edition of the Code of Ethics is available at www.ifac.org.

18 In this section of the paper, "independent" refers to independence of a governing board from an audit firm's management, rather than an audit firm's independence from its clients.

overseeing the auditing firm's management. Securities regulators and legislators have recognized the value of independent oversight of an entity's management in other contexts, including, for example, Section 301 of the U.S. Sarbanes-Oxley Act of 2002, which requires that public company audit committee members be independent.

Objective oversight of accounting firms' management, such as through an independent board, some or all of whose members could be non-practitioners, may have benefits. Such structures could be designed to improve investor protections against auditors' conflicts of interest, and to reinforce auditor independence.[19] For example, independent boards or management advisory boards, to the extent they have controlling voting rights, may help strengthen protections against conflicts of interest by maintaining the public interest perspective within the affairs of the firm. In addition, the board could be charged with oversight of the firm's independence and with management of conflicts of interest and audit quality.[20] The influence of a board of directors, comprised of individuals possessed of independent judgment, could also be established to provide an important mechanism for ensuring that management implements firm-wide policies and procedures designed to create consistency and performance and high levels of audit service quality.[21] Permitting non-practitioner involvement in independent boards also brings risks, however, including, as noted above, that non-practitioners are not subject to the same education,

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19 This concept is consistent with the ideas espoused in the Oxera study, which states that "alternative forms (*e.g.*, investor ownership) could bring additional external monitoring and control, and potentially have a beneficial effect on auditor independence." Oxera Consulting Ltd, *supra* note 7, at 97.

20 In its testimony before the United States Department of the Treasury Advisory Committee on the Auditing Profession, the California Public Employee's Retirement System (CalPERS) stated that:

> State and Federal rules and regulations are important considerations when determining the legal structure of audit firms. Some have suggested that audit firms' structure considerations should include possible corporate structure, public company ownership and non-CPA ownership structures versus the employee (partnership) structure many audit firms have today. CalPERS believes such additional considerations or changes should be researched more fully to ensure these changes do not introduce additional problems into the equation such as increased conflicts of interest. One possible way to decrease this potential conflict of interest would be to introduce independent boards of directors to the audit firm structure.

Written testimony to U.S. Treasury Department Advisory Committee on the Auditing Profession (ACAP) Panel on General Sustainability, Christianna Wood, Senior Investment Officer, Global Equity Investment Office, California Public Employees Retirement System (Feb. 2008), http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Johnson020408.pdf.

In addition, Paul Haaga, Vice Chairman of Capital Research and Management Company, suggested that firms that audit public companies should establish independent boards to, in part, improve governance and monitor potential conflicts. *See Written submissions to the United States Department of the Treasury Advisory Committee on the Auditing Profession*, Paul G. Haaga, Jr., Vice Chairman, Capital Research and Management Company (Feb. 2007), http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Haaga020408.pdf.

21 The Task Force notes that the United States Department of Treasury Advisory Committee on the Auditing Profession also considered the relationship between independent boards and audit quality. United States Department of Treasury, *Advisory Committee on the Auditing Profession Final Report*, Section VII, 10 (Oct. 2008).

competence, and professional standards as certified accountants, and could therefore diminish the fulfillment of the public interest mandate of the firm.

The current restrictions on ownership, moreover, do not appear to eliminate the economic motives of the practitioner-owners, although one may argue that the profit motive is somewhat tempered by the public interest focus of the profession. Specifically, as proprietors of a professional services business, practitioner-owners desire a return on their investment; however, licensed partners are also obligated to perform the attest engagement according to professional standards. These professional obligations encourage accountants to focus on long-term profit maximization goals and returns on their investment, rather than short-term financial incentives that might jeopardize the accountant's compliance with professional standards. Eliminating these market incentives is neither possible nor, at least in totality, necessarily desirable under the current regime of privately-owned audit firms that are paid by their clients. More narrowly tailored restrictions on ownership, which focus on maintaining competence and professionalism and mitigating or prohibiting potential conflicts of interest involving controlling persons and controlling ownership interests or other significant economic relationships, may be feasible, while still promoting auditors' public interest focus and long-term economic goals.

The Task Force seeks public input on the following:

7. **How important are the existing ownership restrictions to audit quality? How else do existing restrictions benefit investors and/or promote audit quality? How may audit quality be negatively affected by permitting alternative forms of audit firm ownership?**

8. **What factors other than those set forth above should regulators consider in analyzing whether alternative forms of audit firm ownership and governance should be allowed?**

9. **Would alternative forms of ownership that include boards of directors with independent members provide a useful reinforcement of auditing firms' public interest obligations and independence? Would other arrangements, such as compulsory charter provisions for audit firms that establish a requirement for partners or directors (licensed or unlicensed) to give due regard to the public interest, be useful?**

10. **Do audit firm non-practitioner employees have economic incentives more in line with practitioner owners than they would have with outside investors? Should ownership by firm employees who are not practitioners be treated differently from outside owners? Would more permissive non-practitioner employee ownership be likely to affect the firms' capital-raising capacity or otherwise affect barriers to entry for audit firms?**

11. **What benefits beyond avoiding additional conflicts of interest associated with non-professional or outside ownership and prohibiting non-qualified professionals from performing audits are realized by existing restrictions on firm ownership?**

V. Possibilities for Further Minimizing Risks and Improving Investor Protection

A. Existing Safeguards

Audit firm regulation currently relies on principles, rules and regulations in addition to ownership restrictions to address certain threats to independence, professionalism and competence. Maintenance of independence is crucial for an external audit, and historically, independence rules have been viewed as one of the most important facets of audit regulation. Standards and safeguards, other than those related to auditing firm ownership, may therefore help provide sufficient protections against threats to independence, professionalism, and competence if alternative ownership arrangements were permitted.

Despite differences in some respects, the independence standards in various jurisdictions appear to be based on similar principles meant to protect auditors' objectivity and integrity. Independence standards across the board seek to promote auditor independence both in fact and appearance, and address services that could impair an auditor's ability to remain objective. In addition, independence standards require firms to avoid mutual or conflicting interests and to refrain from being advocates for their audit clients. These standards also prevent firms from acting as either management or employees of their audit clients and from auditing their own work.

For example, the IFAC Code of Ethics for Professional Accountants prohibits auditors from being directly or indirectly affiliated with clients.[22] Standards based on this precept, which could operate independently of ownership restrictions, protect against the possibility that affiliated entities could exert control over audits. To the extent that the firms and the auditors themselves are required to abide by the existing independence requirements and to monitor and protect the firm's independence, both in fact and in appearance, alternative forms of audit firm ownership could possibly exist compatibly with such standards. If, however, auditing firms or non-practitioner owners expect or require modifications to the existing independence standards, potential conflicts might arise. In addition, depending on the level to which ownership standards are relaxed, implementation and enforcement of independence standards could be more difficult absent the current ownership restrictions, particularly in the case of public ownership of firms.

For existing independence standards to operate consistently with broader non-practitioner ownership of auditing firms, defining the level of concentrated ownership that would raise regulatory concerns about conflicts of interest would be necessary. Some may believe that auditing firms should be independent of all owners and their affiliated entities for the maintenance of independence both in substance and appearance, while others may believe that a *de minimis* level of non-independent owners might be an acceptable trade-off for the potential benefit of increased auditor choice. In this circumstance, if audit firms become widely held

[22] IFAC Code of Ethics, *supra* note 17, at 123–124. Related entities of an audit firm's client include entities that have direct or indirect control over the client provided the client is material to the entity and entities over which the client has direct or indirect control.

public companies with a significant number of owners, a concept for required beneficial ownership reporting, such as the five percent threshold that exists in the United States, could be a way of identifying those owners from which the firm would need to be independent.[23] Designating a *de minimis* threshold could facilitate identifying and pursuing independence violations, because persons with ownership in the firm surpassing such a threshold could be required to identify themselves through public reports to regulators. In this way, audit firms could likewise identify, and maintain independence from, all affiliates of the audit client. This or other approaches to monitoring firms' controls for managing conflicts of interest in a non-practitioner-controlled ownership context would have to be carefully analyzed. Regulators, however, may not be able to identify prospectively all of the possible threats and violations that would occur from broader non-practitioner ownership and, therefore, risk exists that the current or some modified independence regime may not provide equally protective qualities as those provided by the existing ownership restrictions.

B. Additional Safeguards

To address possible risks presented by modifying ownership restrictions, regulators might introduce additional safeguards. Japan, for example, introduced new safeguards when the decision was made to amend the CPA Act to allow firms to admit non-certified public accountant (CPA) partners.[24] For example, the amended CPA Act prohibits non-individuals from becoming owners of audit firms due to concerns that financial dependency on a specific outsider may distort independence of audit firms and adversely affect audit quality. The Act also established other safeguards to avoid non-CPA partners from inappropriately asserting influence on audit quality. Specifically, the Act: (1) includes a ban on executing audit services by non-CPA partners; (2) requires that firms establish an internal control system that includes measures to prevent non-CPA partners from having an inappropriate influence on the execution of audit services; (3) establishes a confidentiality requirement for non-CPA partners; (4) requires that non-CPA partners register with the Japanese Institute of Certified Public Accountants and comply with their Code of Ethics; and (5) provides for administrative sanctions for non-CPA partners.[25]

Additional safeguards could include requiring firms to limit non-practitioner investment to passive ownership, including non-voting shares or shares with restrictions on ownership transfer, or individuals meeting standards akin to fit and proper requirements; as discussed above, appointing independent boards; strengthening quality controls frameworks; and requiring that practitioners continue to manage audit firms and to establish firm standards relating to competence, professionalism and independence. In addition, standards could require firms to enhance their existing quality control systems by implementing procedures to maintain competence, professionalism and independence with respect to the provision of audit services.

23 *See, e.g.*, 17 CFR 240.13d-1(a), U.S. Securities and Exchange Commission's Regulation 13D, requires any person who is directly or indirectly the beneficial owner of more than five percent of a class of certain equity securities to report that ownership on a timely basis.

24 Certified Public Accountants Act, *supra* note 15, at 34-4(3) and 34-13(4).

25 *Id*. at 34-10-2(1); 34-13(2) (iii); 34-10-16; 34-10-8 and 34-10-17.

Similarly, regulators could specifically consider, as part of their regular inspections designed to evaluate firms' ability to prevent conflicts of interest and maintain a high level of competence and professionalism, the appropriateness of a firm's policies and procedures for managing risks associated with non-practitioner ownership arrangements.

The application of U.S. independence standards to existing alternative practice structures provides insights as to possibilities for managing non-practitioner owned firms. Under these alternative practice structures, an audit firm, which is owned and managed by practicing professionals, may be closely aligned with a public company that, *inter alia*, performs non-audit services. The non-audit services company has no direct influence or management responsibilities with respect to the audit firm's practice; however, because the non-audit services firm indirectly benefits from the success of the audit practice (*e.g.*, shared human capital and business referrals to the non-audit services practice), the company is willing to be a source of financial resources for the audit firm. Although few firms have elected to use alternative practice structures,[26] U.S. firms that do so are required to comply with the same independence standards as all other audit firms and are required to address any potential independence threats created by the alternative structure.

The Task Force seeks public input on the following:

12. Could existing safeguards appropriately mitigate concerns regarding competence, professionalism, audit quality and independence if auditing firms were more broadly owned by non-practitioners?

13. What level of non-practitioner ownership should concern regulators, and what level should be considered *de minimis*? Is a securities regulatory model for reporting beneficial ownership useful for this purpose?

14. Could additional safeguards, or adjustments to existing safeguards, adequately ensure that auditing firms maintain their competence, professionalism, audit quality, and independence under broader non-practitioner ownership, including public ownership? If so, what safeguards or adjustments would be needed?

15. What existing risks to any investors might be mitigated by public ownership and which might remain; which might be heightened? What, if any, additional safeguards could regulators implement to address sufficiently any remaining risks?

16. Could new safeguards bring ancillary benefits to the audit process? If so, what are they?

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[26] The results of a study conducted by the GAO indicate that midsize and smaller firms generally do not believe that alternative practice structures present a significant opportunity to increase their large public company audit clients, citing challenges for obtaining the necessary regulatory approvals and the potentially limited effect on increasing a firm's market share. U.S. Government Accountability Office, *supra* note 4, at 49.

17. Could new safeguards bring ancillary detriments to the audit process? If so, what are they?

VI. Impact on Audit Firm Concentration

Predicting whether one or more new competitors would emerge solely if broader forms of non-practitioner or public ownership were permitted is difficult, and few empirical studies exist for the obvious reason that alternative forms of ownership have thus far been limited. New audit firms might not quickly emerge or gain sufficient market share to compete effectively with the largest audit firms. Building market reputation and international networks would likely take years. Furthermore, when evaluating the costs associated with expansion into the large public company audit services market, existing firms may decide that investing new capital into developing the firm's non-audit services practice may provide greater economic return than growing the firm's audit practice.

Some recent studies indicate that market participants believe that access to financial capital by itself may not be a significant impediment to smaller firms that want to compete in the audit market for large public companies.[27] For instance, the 2008 GAO study reported that several firms stated that they are able to raise sufficient funds through debt financing and alternative practice structures and that financing did not significantly obstruct any efforts to expand.[28] Similarly, the Market Participants Group of the UK Financial Reporting Council reported that some market participants "questioned whether any firms would need or wish to raise substantial equity finance given the availability of debt finance."[29] In addition, the fact that few U.S. firms take advantage of alternative practice structures, and firms in EU jurisdictions that permit non-auditors to partially own firms did not take advantage of outside investment, indicates that access to capital and other perceived benefits might be outweighed by other considerations.[30] Thus, even if restrictions on ownership are modified to allow for greater non-practitioner ownership, companies and investors may decide not to enter the large public company audit market if other

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27 *See* Oxera Consulting Ltd, *supra* note 7, at 154–155.

28 U.S. Government Accountability Office, *supra* note 4, at 59-60. The GAO reported that a majority of the accounting firms that GAO surveyed "agreed that being able to raise capital from [outside] sources would have little if any effect on their ability to expand their market share." *Id*. at 59. The GAO study also indicated that 61% of the midsize and smaller firms surveyed stated that providing more financing avenues would "only be slightly effective or not at all effective" in expanding their client base. *Id*. at 60.

29 Market Participants Group of the Financial Reporting Council, *Choice in the UK Audit Market - Final Report of the Market Participants Group*, 19 (Oct 2007), http://www.iasplus.com/uk/0710auditpr.pdf.

30 The Oxera study explained that several EU Member States currently permit non-auditor investors to have a minority interest in a firm, provided that the interest does not exceed 49%, but Oxera was unable to identify any firms in those jurisdictions with minority outside ownership. Oxera Consulting Ltd., *supra* note 7, at 159; *See also* Government Accountability Office, *supra* note 4 at 60 (stating that "firms [said] that the shortage of qualified accountants in the labor market rather than limited access to capital was their primary impediment to growth"). Similarly, the Market Participants Group noted that "some responses [of the Market Participants] doubted whether changes to the ownership rules would benefit auditor choice." Market Participants Group of the Financial Reporting Council, *supra* note 29, at 18. They concluded, however, that, "Market Participants are generally in favour of further consideration of changes to audit firm ownership and control rules." Market Participants Group of the Financial Reporting Council, *supra* note 29 at 19.

barriers to entry are not also addressed prior to, or simultaneously with, the restrictions on firm ownership.[31]

Previous studies on modifying ownership restrictions have, however, concentrated primarily on funding existing small and mid-tier firms' expansion into the large public company audit services market. These studies do not focus on existing ownership restrictions' prevention of non-practitioners' creation of a new large firm to provide audit services to large public companies.[32]

The Task Force seeks public input on the following:

18. What is the likelihood that potential new entrants would take advantage of opportunities for broader non-practitioner ownership, either in the near term or long term?

19. What is the likelihood that one or more of the Big Four firms would take advantage of this option? Were one or more such firms to do so, would the access to additional capital potentially strengthen the firm's capital cushion, thus reducing the likelihood that the audit services market would be further concentrated? Conversely, could this increase concentration, as large firms solidified their market share?

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31 *See* Oxera Consulting Ltd., *supra* note 7, at 197 (noting that "the economic impact of the ownership rules on access to capital needs to be considered in conjunction with . . . other potential barriers").

32 *See, e.g.* Oxera Consulting Ltd., *supra* note 7, at 188–189.

VII. Conclusion

Investors have an abiding interest in audit firm professionalism, competence, and independence, which serve to protect audit quality. Concentration among those firms that supply audit services for large public companies, which regulators have observed for several years, may threaten investor interests because of the risk that the loss of a single firm could disrupt the entire market for independent auditing of large public companies. In addition, greater choice than presently exists and stronger checks and balances than are provided by market discipline might improve the availability of large public company auditing services. Further, allowing for non-practitioner ownership might enlarge the sophisticated pool of human capital with appropriate technical expertise, such as information technology, financial engineering, or legal services, which could contribute to improvements in the quality of audits and firm governance. These potential benefits, however, do not justify a compromise to audit quality, which is essential to investor protection. Since auditors' opinions are expected to enhance the reliability of reported financial information, investors should be able to expect objectivity, independence, professionalism and competence from auditors.

Reconciling the parallel regulatory objectives of audit firm professionalism, competence, and independence, on the one hand, and of mitigating concentration in the marketplace for large public company auditing services, on the other, justifies exploration of alternatives to current ownership restrictions for auditing firms. Reconsidering these limitations may have the potential to result in new competitors to the Big Four firms. Moreover, the entry of new competitors could introduce alternative forms of audit firm governance to the market for large public company audits, such as independent directors on a board responsible for overseeing management. This circumstance might buttress existing auditing firm policies and procedures designed to minimize conflicts of interest, maintain independence, and promote audit quality.

Consideration of the potential benefits of permitting broader firm ownership by non-accounting practitioners requires that securities regulators, legislators, professional bodies, and standard-setters carefully analyze its impact on competence, professionalism, conflicts of interest, and independence. In addition, standard setters, professional bodies, regulators and legislators should consider whether new or enhanced safeguards could successfully mitigate the risks presented by non-practitioner ownership.

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APPENDIX 1

IOSCO TASK FORCE ON AUDIT SERVICES

Consultation Report on the Exploration of Non-Professional Ownership Structures for Audit Firms

Interim Chairman: Mr. Ethiopis Tafara
US Securities and Exchange Commission

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Austrialian Securities and Investments Commission (Australia)	Mr. Mark Adams Mr. Lee White
Comissão de Valores Mobiliários (Brazil)	Mr. Eduardo Manhães
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